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No. 94-2027

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1995

MONTGOMERY SECURITIES and PAINEWEBBER INC.,

Petitioners,

vs.

RICHARD B. DANNENBERG, MINDY BLITZ, EUGENE COSTIGLIO, KENNETH H. ROSS, HOMER FLEISHER, STEVEN G. COOPERMAN, NATHANIEL ORME, ERVIN H. FISHMAN, FREDERICK WERTHEIMER, BARBARA WERTHEIMER, WILLIAM J. BING, ARLENE S. BING, TRUSTEES OF WILLIAM J. BING AND ARLENE S. BING LIVING TRUST, ANTHONY D. SHAPIRO, WILLIAM DULUDE, H.N. BROWN, JR., DAVID E. LOCKROW, KARL E. BAUMAN, LUCILLE C. BAUMAN, AND JACK SCHNITZER, On Behalf of Themselves and All Others Similarly Situated,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. In a case where the evidence was held sufficient to establish *deliberate concealment* of the truth, should this Court opine on the abstract question whether recklessness also would be sufficient to satisfy the scienter requirement of Section 10(b) of the Securities Exchange Act of 1934, and, if so, whether it is necessary to distinguish between "objective" and "subjective" recklessness?

2. When information is expressly "required to be stated" within the meaning of Section 11 of the Securities Act of 1933, and its omission causes a prospectus and registration statement to be misleading, can the information be withheld because its omission does not make any particular representation, viewed in isolation, misleading?

TABLE OF CONTENTS

Page

I. STATEMENT OF THE CASE 1

II. SUMMARY OF ARGUMENT 7

III. ARGUMENT 10

A. Because The Evidence Presented Is Sufficient To Support An Inference Of Deliberate Concealment, The Underwriters' Arguments Regarding Whether Recklessness Might Also Suffice Are Not Properly Presented 10

B. Even If The Question Were Properly Presented, It Is Well-Settled That Reckless Conduct Is "Intentional" Or "Knowing" For Purposes Of Section 10(b)'s Scienter Element 10

C. There Is No Conflict Among The Circuits Regarding The Showing Required To Establish Recklessness Under Section 10(b) 14

D. The Petition Presents No Substantial Question Regarding The Scope Of Liability Under Sections 11 and 12 18

IV. CONCLUSION 24

TABLE OF AUTHORITIES

Page

CASES

Arkwright v. Newbold, 17 Ch. D. 301 (1881) 14

Benchwick v. United States, 297 F.2d 330 (9th Cir. 1961) 18

Broad v. Rockwell Int'l Corp., 642 F.2d 929 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981) 11, 15

Cook v. Avien, Inc., 573 F.2d 685 (1st Cir. 1978) 15

Cooper v. Schlesinger, 111 U.S. 148 (1884) 12

Derry v. Peek, 14 App. Cas. 337 (H.L. 1889) 14

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) ... 11, 12

Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544 (E.D.N.Y. 1971) 23

Franke v. Midwestern Oklahoma Development Authority, 428 F. Supp. 719 (W.D. Okla. 1976), *vacated on other grounds*, 619 F.2d 856 (10th Cir. 1980) 15

Frankel v. Wyllie & Thornhill, Inc., 537 F. Supp. 730 (W.D. Va. 1982) 16

Greenapple v. Detroit Edison Co., 618 F.2d 198 (2d Cir. 1980) 23

Hackbart v. Holmes, 675 F.2d 1114 (10th Cir. 1982) ... 11, 16

Herman & MacLean v. Huddleston, 459 U.S. 375 (1983) 18

Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991) 11, 16, 17

K&S Partnership v. Continental Bank, N.A., 952 F.2d 971 (8th Cir. 1991), *cert. denied*, ___ U.S. ___, 112 S. Ct. 2993 (1992) 16

TABLE OF AUTHORITIES – Continued

Page

Kriner v. Dinger, 297 Pa. 576, 147 A. 830 (1929)..... 14

Lehigh Zinc & Iron Co. v. Bamford, 150 U.S. 665 (1893)..... 12

Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979)..... 11

McLean v. Alexander, 599 F.2d 1190 (3d Cir. 1979) ...11, 15

McMahan & Co. v. Wherehouse Entertainment, 900 F.2d 576 (2d Cir. 1990), *cert. denied*, 501 U.S. 1249 (1991)..... 22

Ohio Drill & Tool Co. v. Johnson, 625 F.2d 738 (6th Cir. 1980)..... 15

Otis & Co. v. Grimes, 97 Colo. 219, 48 P.2d 788 (1935)..... 14

PPM America, Inc. v. Marriott Corp., 875 F. Supp. 289 (D. Md. 1995)..... 16

In re Phillips Petroleum Sec. Litig., 881 F.2d 1236 (3d Cir. 1989)..... 18

Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978)..... 11, 13, 15

Rubinstein v. Collins, 20 F.3d 160 (5th Cir. 1994) 15

SEC v. Carriba Air, Inc., 681 F.2d 1318 (11th Cir. 1982)..... 16

SEC v. Software Toolworks, Inc., et al., Civ. No. 93-3581(FMS) (N.D. Cal.)..... 3

SEC v. Steadman, 967 F.2d 636 (D.C. Cir. 1991) ...11, 16

Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982)..... 15

TABLE OF AUTHORITIES – Continued

Page

Stokes v. Lokken, 644 F.2d 779 (8th Cir. 1981)..... 11

Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977) 8, 11, 15, 16, 17

Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931)..... 14

United States v. Cohen, 516 F.2d 1358 (8th Cir. 1975) 18

United States v. Sullivan, 406 F.2d 180 (2d Cir. 1969) 18

Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 111 S. Ct. 2749 (1991) 12

Woods v. Barnett Bank of Fort Lauderdale, 765 F.2d 1004 (11th Cir. 1985)..... 11

STATUTES, RULES AND REGULATIONS

Securities Act of 1933

§11, 15 U.S.C. §77k..... *passim*

§12(2), 15 U.S.C. §77l(2)..... *passim*

Securities Exchange Act of 1934

§10(b), 15 U.S.C. §78j(b) ..... *passim*

§14(a), 15 U.S.C. §78n(a)..... 12

Federal Rules of Civil Procedure

Rule 54(b)..... 3

TABLE OF AUTHORITIES – Continued

Page

Securities and Exchange Commission Regulations

Item 10 of Regulation S-K, 17 C.F.R. §229.10 21

Item 303 of Regulation S-K, 17 C.F.R. §229.303. . . . 19, 20

SECONDARY AUTHORITIES

Melville M. Bigelow, *The Law of Fraud* (1877) §3..... 12

W. Page Keeton, Dan B. Dobbs, Robert E. Keeton & David G. Owen, *Prosser and Keeton on the Law of Torts* (5th ed. 1984) §107 13

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BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

I. STATEMENT OF THE CASE

This case arises out of a fraudulent offering of stock in violation of provisions of the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").

On July 10, 1990, Software Toolworks, Inc. ("Toolworks" or the "Company") sold common stock through a

public offering registered with the Securities and Exchange Commission ("SEC") on Form S-1. Petitioners in this Court, Montgomery Securities and PaineWebber, Inc., were the underwriters for the offering ("Underwriters"). The firm of Deloitte & Touche ("Deloitte") acted as Toolworks' independent accountants.

To market the offering, Toolworks and its officers misled investors and the SEC by falsifying the Company's financial results and omitting crucial information from the prospectus and registration statement for the offering. The offering was successfully marketed to investors by creating expectations of strong financial performance in fiscal 1991 (beginning April 1, 1990). The offering was initially planned to close late in the first quarter of fiscal 1991, ending June 30, 1990, and optimism about the "June quarter" was of critical importance to investors.

However, the offering was delayed and Toolworks concluded the quarter before the registration statement became effective. On July 3, 1990, the SEC, which was reviewing the registration statement, told Toolworks that it should disclose "preliminary results" for the June quarter in the prospectus. (A22). Although such results were both available and unfavorable, Toolworks, the Underwriters and Deloitte jointly drafted a July 4, 1990 letter to the SEC falsely representing that such data was *not* available but that Toolworks anticipated revenue for the quarter of between $21 and $22 million – which was also false. (A14-A18, A21-A22). In fact, the Company had booked phony sales in order to make the June quarter appear profitable.

As a consequence of these false representations, the SEC allowed the offering to proceed with no reference to the recently completed June quarter. The Company's registration statement became effective and Toolworks successfully sold more than $71 million of common stock. (A2). A few months later, when the truth caught up with Toolworks, the Company's stock dropped from its offering price of $18.50 to just $2.375. (A2).

This action ensued with the filing of a Complaint under §11 and §12(2) of the Securities Act of 1933, and §10(b) of the Exchange Act. The defendants included Toolworks, certain of its officers and directors, as well as Deloitte and the Underwriters. Toolworks and its officers quickly settled with plaintiffs for $26.5 million. (A3).

Thereafter, the district court granted summary judgment to the Underwriters and Deloitte in this case on virtually all of plaintiffs' claims. The district court held that the Underwriters met their affirmative "due diligence" defense under §11 and §12(2) as a matter of law, (A27-A36), and therefore plaintiffs also could not establish scienter for their claims under §10(b). (A36-A42). The district court similarly granted summary judgment to Deloitte on most of plaintiffs' case. (A43-A66). Plaintiffs perfected an appeal after obtaining a Rule 54(b) certification.[1]

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[1] While this case was pending on appeal in the Ninth Circuit, the SEC successfully pursued an enforcement action against Toolworks and certain of its officers based on "substantially the same facts and questions of law" as this case. *SEC v. Software Toolworks, Inc., et al.*, Civ. No. 93-3581(FMS) (N.D. Cal.) ("SEC Enforcement Action") Notice of Related Case at 1 (Sept.

Before the district court and the Ninth Circuit, the Underwriters argued that they had acted with due diligence as a matter of law, and that no reasonable jury could infer that they had acted with scienter. They did not raise any of the arguments presented now in their Petition for Writ of Certiorari. For example, nothing in the Underwriters' arguments in the lower courts suggested that liability under §10(b) may not be grounded on reckless indifference to the truth, much less that there is any distinction between "objective" and "subjective" recklessness. Nowhere did the Underwriters argue that §11 and §12(2) are designed to permit the issuance of a misleading prospectus and registration statement so long as no particular statement therein is false when considered in isolation.

The Ninth Circuit reversed in part and affirmed in part. With respect to the §11 and §12(2) claims, it held

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30, 1993). According to the SEC, Toolworks committed fraud in its registration statement on Form S-1 for the July 1990 offering as part of "a scheme to conceal, among other things, the company's drastically deteriorating sales during mid-1990," and "the effect that the deterioration was having on the company's income." SEC Enforcement Action, Complaint ¶16 (Sept. 29, 1993). The district court found that the SEC Enforcement Action was a "related case," and entered final judgments in the SEC Enforcement Action enjoining further fraudulent activity, ordering individual defendants to disgorge over $2.5 million, and barring Toolworks' Chief Financial Officer from ever again acting as an officer or director of any publicly traded company subject to registration and reporting requirements of the federal securities laws. SEC Enforcement Action, orders dated October 13, 1993.

that the Underwriters carried their burden of demonstrating "due diligence" as a matter of law with respect to certain alleged defects in the prospectus and registration statement, but not as to others. (A4-A13). Similarly, it held that while plaintiffs failed to demonstrate scienter with respect to some allegations, they succeeded as to others. Most significantly, the Court of Appeals held that the evidence was sufficient to show that the Underwriters and Deloitte *deliberately falsified and concealed the truth* with respect to the poor results for the June quarter. (A15-A18, A21-A23).

Thus, the Underwriters' "Statement of the Case" misrepresents the record in several respects. According to the Underwriters, "[t]he Ninth Circuit affirmed the district court's conclusion that the Underwriters had properly investigated all matters discussed in the prospectus." Petition for Writ of Certiorari ("Pet.") at 4. In fact, the Ninth Circuit held that the prospectus and registration statement were incomplete and could be deemed misleading for failure to discuss material data known to the defendants about the results for the June quarter:

> The Underwriters' contention that the events of this period are inapplicable to sections 11 and 12(2) liability is clearly incorrect. *Both statutory provisions require disclosure of information needed in order to make a prospectus truthful and not misleading.*

(A13 n.2) (emphasis added).

The Underwriters also represent that "[t]he Ninth Circuit did not identify any evidence that would have given the Underwriters reason to suspect that preliminary numbers [for the June quarter] were available, when

Toolworks and its counsel said [to the SEC] that they were not." Pet. at 4. This is flatly wrong. Evidence showed that Toolworks "had acknowledged to the professionals participating in the offering that some financial data for the quarter actually was available." (A22). The Ninth Circuit held that on the evidence presented, "[a] reasonable factfinder could infer that, as members of the drafting group, *the Underwriters had access to all information that was available and deliberately chose to conceal the truth.*" (A15) (emphasis added).[2]

Far from innocently relying on them, the Underwriters themselves actually helped to draft the Company's misrepresentations to the SEC – as the Ninth Circuit's opinion explains:

> The Underwriters claim that they were not involved in drafting the July 4 SEC letter and that, as a result, they have no responsibility for its contents. *The plaintiffs presented evidence, however, that the letter was a joint effort of all professionals working on the offering, including the Underwriters.* In fact, a Riordan & McKinzie partner specifically testified that, "[w]hen the

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[2] Record evidence showed that the Underwriters participated in a conference call regarding the SEC's comments in which they were told that preliminary results for the quarter were available, and in which they helped "outline[ ] what our response would be." Ninth Circuit Excerpts of Record ("ER") 317/Sylvester deposition:16-19; ER 316/277, 2013. After a draft response was prepared reflecting what Toolworks had told the entire working group – that preliminary data for the quarter *was* available – the letter was revised to falsely represent that such data was *not* available, but nonetheless to confirm expectations of $21 million in revenues and $3 to $4 million in profits for the quarter. *Compare* ER 289/285 *with* 316/2006.

> letter finally went to the SEC, all parties had been involved in the process of creating it. There had been conference calls discussing it and comments and changes made by a lot of different members of the working group." [ER 317/Weeks:40-41]. *Others similarly testified that the Underwriters were actively involved in discussions of how to respond to the SEC's inquiries regarding the June quarter.* [*See* ER 317/Barker:23-24; ER 317/Sylvester: 18-19].

(A15) (emphasis added).

Finally, the Underwriters assert that "the Underwriters' actual mental state was irrelevant to the court's analysis." Pet. at 5. That is not true. Again, the court held that a reasonable trier of fact could conclude that the Underwriters *"deliberately chose to conceal the truth."* (A15, A18) (emphasis added).

II. SUMMARY OF ARGUMENT

The "Questions Presented" by the Underwriters were neither raised nor decided below. Generally speaking, an issue should be presented to a court of appeal before it is presented on petition for certiorari. However, even if this defect could be overlooked, the case is not an appropriate one for this Court's review. The questions themselves are not presented on the factual record in this case, and are insubstantial in any event.

The Underwriters say that this case presents the question whether recklessness can suffice to establish scienter under §10(b). This question is not properly presented. The Ninth Circuit held that on the record in this case, "[a] reasonable factfinder could infer that . . . the

Underwriters had access to all information that was available *and deliberately chose to conceal the truth.*" (A15, A18) (emphasis added).

The Underwriters' assertion that lower courts are in "disarray" regarding the scienter standard for §10(b) actions is nonsense. The lower courts uniformly hold that recklessness suffices to establish scienter under §10(b), and far from disagreeing about what constitutes reckless conduct, the lower courts uniformly apply the so-called "*Sundstrand*-standard" articulated in *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044-45 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

Moreover, Congress is currently considering legislation addressing the scienter standard for §10(b) actions. H.R. 1058 passed the House of Representatives on March 8, 1995, and S.240 passed the Senate on June 28, 1995. For this Court to grant certiorari to determine whether recklessness satisfies the scienter requirement of §10(b), or to determine what the correct recklessness standard should be, even if it were otherwise appropriate, makes no sense with legislation pending.

In short, there is no conflict among the circuits, no substantial disagreement regarding the controlling legal standard for recklessness, and no reason for this Court to intervene in order to make new law.

The Underwriters' contentions regarding liability under §11 of the Securities Act are equally insubstantial. Section 11 imposes liability if "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact *or omitted to state a material fact required to be stated therein* or necessary to

make the statements therein not misleading . . . . " 15 U.S.C. §77k(a) (emphasis added). Information regarding the completed quarter that ended June 1990 was "required to be stated" within the meaning of §11, but was omitted from the prospectus and registration statement. The information was required by Item 303 of Regulation S-K. 17 C.F.R. §229.303. The SEC told Toolworks and the Underwriters that the information should be included in the prospectus and registration statement. (A22). The Underwriters' own experts testified that disclosure of this data was required. (A13 n.2).

The Underwriters' argument that the information was not required to be included in the prospectus is based on a misquotation of §11 that omits the operative statutory language, a real or feigned ignorance of the specific requirements of SEC regulations governing registration statements, and a gross mischaracterization of the Ninth Circuit's opinion. The Underwriters' assertion that §11 permits misleading prospectuses so long as no particular statement in the prospectus, taken in isolation, is literally false, is simply ludicrous.

Whether the Underwriters acted with scienter, and whether the prospectus and registration statement were misleading are, in any event, questions of fact. If it is necessary for this case to occupy this Court's time, it can be dealt with at a later stage in this litigation – on a full record after a trier of fact has rendered a verdict. There is no reason for the Court to intervene at this preliminary stage.

III. ARGUMENT

A. Because The Evidence Presented Is Sufficient To Support An Inference Of Deliberate Concealment, The Underwriters' Arguments Regarding Whether Recklessness Might Also Suffice Are Not Properly Presented

The Underwriters' first Question Presented asks "[i]s recklessness sufficient to satisfy the scienter requirement of Section 10(b) of the Securities Exchange Act of 1934, and if so, is it necessary to show at least subjective (*i.e.*, conscious) recklessness?" But the Ninth Circuit's decision regarding the Underwriters does not turn on recklessness at all. Given the evidence presented by plaintiffs, the Ninth Circuit held: "A reasonable factfinder could infer that . . . the Underwriters . . . *deliberately chose to conceal the truth.*" (A15, *see also* A18, A22) (emphasis added). That is far more than recklessness.

Because deliberate fraud satisfies §10(b)'s scienter requirement without resort to concepts of recklessness, the Underwriters' first "Question Presented" is not presented at all. Moreover, because deliberate fraud involves subjectively "conscious" conduct, none of the Underwriters' arguments regarding purported distinctions between "objective recklessness" and "subjective recklessness" can have any significance on the record in this case.

B. Even If The Question Were Properly Presented, It Is Well-Settled That Reckless Conduct Is "Intentional" Or "Knowing" For Purposes Of Section 10(b)'s Scienter Element

The question whether reckless disregard suffices to establish scienter should not consume this Court's time in any event.

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) this Court recognized that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct," indicating, without deciding, that it could satisfy the scienter requirement of §10(b). *Id.* at 193 n.12. The Court stated that §10(b) proscribes "knowing or intentional misconduct," *id.* at 193 n.12, 197, but cautioned that recklessness might be considered "a form of intentional conduct" for these purposes. *Id.* at 193 n.12. Every court to consider the issue has concluded that reckless conduct does suffice to establish scienter.[3]

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[3] *See, e.g., Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 960-61 (5th Cir.) (en banc), *cert. denied*, 454 U.S. 965 (1981); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024 (6th Cir. 1979); *Sundstrand*, 553 F.2d at 1044; *Stokes v. Lokken*, 644 F.2d 779, 783 (8th Cir. 1981); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc), *cert. denied*, 499 U.S. 976 (1991); *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir. 1982); *Woods v. Barnett Bank of Fort Lauderdale*, 765 F.2d 1004, 1010 (11th Cir. 1985); *SEC v. Steadman*, 967 F.2d 636, 641-42 (D.C. Cir. 1991).

The Underwriters argue that the circuit courts are all wrong because *Ernst & Ernst* requires "knowing or intentional misconduct." But a statement made with reckless disregard for its truth *is a knowing falsehood*. In *Cooper v. Schlesinger*, 111 U.S. 148, 155 (1884), this Court held that "the jury were properly instructed that *a statement recklessly made*, without knowledge of its truth, *was a false statement knowingly made*."[4] This was hornbook law when Congress enacted the federal securities acts, just as it is hornbook law today.[5] As a matter of law, "reckless

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[4] *Id.* at 155 (emphasis added). In *Lehigh Zinc & Iron Co. v. Bamford*, 150 U.S. 665 (1893), this Court held that "a person who makes representations of material facts, assuming or intending to convey the impression that he has actual knowledge of the existence of such facts, when he is conscious that he has no such knowledge, is as much responsible for the injurious consequences of such representations, to one who believes and acts upon them, as if he had actual knowledge of their falsity . . . . " *Id.* at 673. Nearly a century later, in *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 111 S. Ct. 2749, 2758 (1991), this Court held in a case arising under §14(a) of the Exchange Act that public representations "in a commercial context are reasonably understood to rest on a factual basis that justifies them as accurate, the absence of which renders them misleading." Thus, a statement made with knowledge that it lacks a reasonable basis is a statement made with knowledge of its misleading character – that is, *with intent to mislead* or defraud. *See Lehigh Zinc*, 150 U.S. at 673; *Cooper*, 111 U.S. at 155.

[5] The leading hornbook on the law of fraud before the enactment of the federal securities statutes explained: "[I]f a man makes a positive representation of fact, believing it to be true, without having any information or any adequate information upon which to base it . . . *he then acts, to his own knowledge, falsely* . . . . " Melville M. Bigelow, *The Law of Fraud* §3, at 62-63

conduct is viewed as a form of knowing conduct," and making statements with a reckless indifference to their truth or falsity is just one variety of intentional or knowing falsehood. *Rolf*, 570 F.2d at 45.

The Underwriters further contend that all the circuits are wrong because §10(b) liability should be imposed only where defendants lack an honest belief in the truth and completeness of what they said. But a reckless statement is not a statement *honestly* made:

> "[A] representation recklessly made, without knowledge of its truth, cannot be a statement honestly believed, but, on the contrary, is regarded as a false statement knowingly made. . . . [I]n putting his statement in such form as to amount to an assertion that he has knowledge of its truth, [one] is guilty of an intentional falsehood."

(1877) (emphasis added). Today's leading hornbook on the law of torts restates the principle:

> There is of course no difficulty in finding the required *intent to mislead* where it appears that the speaker believes his statement to be false. Likewise, there is general agreement that *it is present when the representation is made without any belief as to its truth, or with reckless disregard whether it be true or false.* Further than this, it appears that all courts have extended it to include representations made by one who is conscious that he has no sufficient basis for information to justify them.

W. Page Keeton, Dan B. Dobbs, Robert E. Keeton & David G. Owen, *Prosser and Keeton on the Law of Torts* §107, at 741-42 (5th ed. 1984) (emphasis added, footnotes omitted).

Otis & Co. v. Grimes, 97 Colo. 219, 222, 48 P.2d 788, 789 (1935) (citation omitted); *see also Kriner v. Dinger*, 297 Pa. 576, 582, 147 A. 830, 832 (1929).

"Fraud," wrote Justice Cardozo, "includes the pretense of knowledge when knowledge there is none." *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931). Even the old English decisions on which the Underwriters rely recognized this: "For a man who makes a statement without care and regard for its truth or falsity commits a fraud. He is a rogue."[6]

In short, there is no conflict among the circuits, and no reason to think the circuit courts are wrong. As noted above, Congress appears to be in the process of codifying standards for §10(b) liability in any event. *See* H.R. 1058 (*passed* March 8, 1995); S.240 (*passed* June 28, 1995).

C. There Is No Conflict Among The Circuits Regarding The Showing Required To Establish Recklessness Under Section 10(b)

The Underwriters argue that the lower courts are "in disarray" about the standard for determining whether conduct is reckless under §10(b). They are wrong.

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[6] *Derry v. Peek*, 14 App. Cas. 337, 350 (H.L. 1889) (Lord Bramwell). They held that reckless misrepresentations are by no means "innocent" misrepresentations. *See Arkwright v. Newbold*, 17 Ch. D. 301, 320 (1881) (Cotton, L.J.) ("in an action of deceit the representation to found the action *must not be innocent*, that is to say, it must be made either with knowledge of its being false, *or with a reckless disregard* as to whether it is or is not true") (emphasis added).

One circuit after another has adopted the so-called "*Sundstrand* standard," first articulated in *Franke v. Midwestern Oklahoma Development Authority*,[7] and adopted by the Seventh Circuit in *Sundstrand*, 553 F.2d at 1044-45. Under *Sundstrand*:

> " '[R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.' "

Id. at 1045 (citation omitted).

Sundstrand's formulation has become a uniform national standard, explicitly adopted and applied by the First,[8] Second,[9] Third,[10] Fifth,[11] Sixth,[12] Seventh,[13]

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[7] 428 F. Supp. 719, 725 (W.D. Okla. 1976), *vacated on other grounds*, 619 F.2d 856 (10th Cir. 1980).

[8] *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978).

[9] *Rolf*, 570 F.2d at 47.

[10] *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 193 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); *McLean*, 599 F.2d at 1197-98.

[11] *Broad*, 642 F.2d at 960-61; *Rubinstein v. Collins*, 20 F.3d 160, 169 (5th Cir. 1994).

[12] *Ohio Drill & Tool Co. v. Johnson*, 625 F.2d 738, 741 (6th Cir. 1980).

[13] *Sundstrand*, 553 F.2d at 1044-45.

Eighth,[14] Ninth,[15] Tenth,[16] Eleventh,[17] and District of Columbia[18] Circuits – as well as by district courts in the Fourth Circuit.[19] No circuit court has rejected the *Sundstrand* standard.

Nonetheless, the Underwriters try to manufacture a conflict among the circuits by contending that some courts require "subjective" recklessness, while others require "objective" recklessness. Such distinctions are products of the Underwriters' imagination, and can have no relevance in this case, for the Ninth Circuit again held that on the evidence presented "[a] reasonable factfinder could infer that . . . the Underwriters . . . *deliberately chose to conceal the truth.*" (A15). There is nothing ambiguous about the Ninth Circuit's focus on the *subjective* and *deliberate* intent of the Underwriters. Thus, the Underwriters' contentions that the Ninth Circuit's decision turned on some hypothetical distinction between "objective recklessness" and "subjective recklessness" is patent nonsense. Moreover, any distinction between "objective" and "subjective" recklessness is inconsequential at the summary judgment stage. For if the evidence sufficiently

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[14] *K&S Partnership v. Continental Bank, N.A.*, 952 F.2d 971, 978 (8th Cir. 1991), *cert. denied*, ___ U.S. ___, 112 S. Ct. 2993 (1992).

[15] *Hollinger*, 914 F.2d at 1569-70.

[16] *Hackbart*, 675 F.2d at 1118.

[17] *SEC v. Carriba Air, Inc.*, 681 F.2d 1318, 1324 (11th Cir. 1982).

[18] *SEC v. Steadman*, 967 F.2d at 641-42.

[19] *PPM America, Inc. v. Marriott Corp.*, 875 F. Supp. 289, 301-02 (D. Md. 1995); *Frankel v. Wyllie & Thornhill, Inc.*, 537 F. Supp. 730, 740 (W.D. Va. 1982).

demonstrates that the Underwriters were "objectively" reckless, how can they argue that a jury may not determine that they were in fact "subjectively" reckless?

The Underwriters contend that the Ninth Circuit follows an "objective recklessness" standard that allows liability to be grounded on mere negligence. But sitting en banc in *Hollinger*, 914 F.2d at 1569, the Ninth Circuit expressly rejected negligence as a basis of liability under §10(b), holding that to satisfy *Sundstrand's* recklessness standard a defendant's conduct " 'must derive from something more egregious than even "white heart/empty head" good faith.' " *Hollinger*, 914 F.2d at 1569-70 (quoting *Sundstrand*, 553 F.2d at 1045). In the decision below, the Ninth Circuit again expressly held that " 'recklessness' is conduct 'involving *not merely simple or even inexcusable negligence* . . . . ' " (A17) (quoting *Hollinger*, 914 F.2d at 1569 (quoting *Sundstrand*, 553 F.2d at 1044-45)). It rejected a portion of plaintiffs' claims against Deloitte because "[a]t most, the evidence establishes that Deloitte was negligent in auditing Toolworks, not that Deloitte recklessly or knowingly falsified the financial statements." (A20).

Those who misstate or conceal the truth seldom candidly admit that they did so with scienter. As a consequence, direct evidence of intent to defraud or recklessness seldom exists, and proof of state of mind almost always requires resort to objective evidence regarding the circumstances surrounding the defendant's

conduct.[20] In *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 n.30 (1983), this Court recognized that "the proof of scienter required in fraud cases is often a matter of inference from circumstantial evidence," as it warned against adopting a high standard of proof for scienter in securities fraud cases. The fact that scienter may be inferred from objective circumstances cannot be transformed into any "conflict" between "objective recklessness" and "subjective recklessness" that requires review by this Court.

D. The Petition Presents No Substantial Question Regarding The Scope Of Liability Under Sections 11 and 12

The Underwriters' second "Question Presented" to the Court is:

> Under Section 11 and Section 12(2) of the Securities Act of 1933, does the fact that information is "material" create an affirmative duty of disclosure, even though the information does not render misleading any statement in the prospectus or registration statement?

This question is not presented at all. Section 11 imposes liability if "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact *or omitted to state a material fact required to be stated therein* or necessary to

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[20] *See In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1241 (3d Cir. 1989); *United States v. Cohen*, 516 F.2d 1358, 1367 (8th Cir. 1975); *United States v. Sullivan*, 406 F.2d 180, 186 (2d Cir. 1969); *Benchwick v. United States*, 297 F.2d 330, 333 n.5 (9th Cir. 1961).

make the statements therein not misleading . . . . " 15 U.S.C. §77k(a) (emphasis added). The omitted information in this case was *required to be stated* within the meaning of §11.[21]

The omitted information was required to be disclosed by Item 303 of Regulation S-K, which requires the registrant to provide specific information regarding liquidity, capital resources, and results of operations, as well as any other information "necessary to an understanding of its financial condition, changes in financial condition and results of operations." Reg. S-K, Item 303(a), 17 C.F.R. §229.303(a). The registrant must "[i]dentify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way." Reg. S-K, Item 303(a)(1), 17 C.F.R. §229.303(a)(1). The registrant must "[d]escribe any known material trends, favorable or unfavorable, in

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[21] The Underwriters' effort to manufacture a question for this Court actually requires them to misquote §11 itself. In their Petition for Writ of Certiorari, crucial words of the statutory text disappear in an ellipsis:

> Section 11 and Section 12(2) by their terms require the identification of a specific statement that is either untrue, or that is rendered misleading by an omitted fact. Section 11 provides that the plaintiff must prove that the registration statement "contain[s] an untrue statement of a material fact or omit[s] to state a material fact . . . necessary to make *the statements therein* not misleading."

Pet. at 24 (misquoting 15 U.S.C. §77k(a)) (emphasis added by Underwriters). This is an outrageous misquotation of the statute.

the registrant's capital resources," and "[i]ndicate any expected material changes in the mix and relative cost of such resources." Reg. S-K, Item 303(a)(2)(ii), 17 C.F.R. §229.303(a)(2)(ii). Finally, the registrant must:

> Describe any known trends or uncertainties *that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.* If the registrant knows of events that will cause a material change in the relationship between costs and revenues . . . the change in the relationship shall be disclosed.

Reg. S-K, Item 303(a)(3)(ii), 17 C.F.R. §229.303(a)(3)(ii) (emphasis added).

As a consequence, *"the SEC told Toolworks that it should disclose 'preliminary results' for the June quarter in the prospectus."* (A22) (emphasis added). Moreover, the Underwriters' own experts testified that this information was required, as the Ninth Circuit recites:

> *As the Underwriters' own experts testified,* poor first quarter earnings prior to the effective date of the offering would definitely constitute material information and *would have to be disclosed.*

(A13 n.2) (emphasis added); *see* ER 290/Isgur deposition: 270-72; ER 290/Farr deposition: 210-13.

Contending that the Ninth Circuit, the SEC and their own experts were wrong, the Underwriters now assert that the Ninth Circuit never considered whether the information was required. Pet. at 24-25 n.19. That is ludicrous. In the alternative, they contend that Item 303 of Regulation S-K does not even apply to registration statements governed by §11. Pet. at 24-25 n.19. This too is

flatly wrong. By its terms, Regulation S-K applies to "[r]egistration statements under the Securities Act . . . to the extent provided in the forms to be used for registration under such Act,"[22] and Form S-1 expressly requires the "[i]nformation required by Item 303 of Regulation S-K, management's discussion and analysis of financial condition and results of operations."[23] Toolworks filed its registration statement for the July 1990 offering on Form S-1, and thus was required to comply with Item 303.

Because the omitted information was required to be disclosed, it is not necessary to determine whether its absence also made the registration statement misleading. *See* 15 U.S.C. §77k(a). However, failure to disclose the disastrous June quarter results did make the prospectus and registration statement misleading, because it did not adequately inform investors regarding the real state of Toolworks' business. Concealing the fact that the Company's just-completed quarter was a disaster made the

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[22] Reg. S-K, Item 10, 17 C.F.R. §229.10.

[23] Form S-1, Item 11(h); *see also* Form S-2 Item 11(b)(7) ("Furnish management's discussion and analysis of the registrant's financial condition and results of operations required by Item 303 of Regulation S-K."). Even where registrants are permitted to incorporate information by reference to filings on Forms 10-K and 10-Q, which defendants concede are subject to Item 303 of Regulation S-K, the registrant must "[d]escribe any and all material changes in the registrant's affairs which have occurred since the end of the latest fiscal year for which certified financial statements were included in the latest annual report to security holders and which were not described in a Form 10-Q or quarterly report delivered with the prospectus . . . . " Form S-2, Item 11(a)(4); *see also* Form S-3, Item 11(a); Form S-4, Item 12(a)(4).

prospectus and registration statement plainly misleading. This fact was effectively conceded by the Underwriters' own witnesses, who admitted that if the truth had been told about the quarter, the offering would have been cancelled. ER 290/Isgur deposition: 270-72; *see also* ER 290/Farr deposition: 210-13; ER 341/Meyers deposition: 149-51. The Ninth Circuit thus held that Plaintiffs presented evidence sufficient for a jury to conclude that the prospectus and registration statement were misleading. (A13 n.2).

The Underwriters contend that nonetheless, no particular statement in the registration statement was literally false. The Underwriters ask this Court to assume that §11 and §12(2) implicitly draw some metaphysical distinction between a misleading registration statement and the misleading statements that together constitute the registration statement. Pet. at 24. This is ludicrous. Courts have always understood §11 to prohibit misleading registration statements. They have always held that specific statements within a registration statement must be evaluated in context to determine whether they operated together to convey a misleading impression:

> Some statements, although literally accurate, can become, through their context and manner of presentation, devices which mislead investors. For that reason, the disclosure required by the securities laws is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead prospective buyers.

McMahan & Co. v. Wherehouse Entertainment, 900 F.2d 576, 579 (2d Cir. 1990), *cert. denied*, 501 U.S. 1249 (1991); *see,*

e.g., Greenapple v. Detroit Edison Co., 618 F.2d 198, 205 (2d Cir. 1980); *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 563-66 (E.D.N.Y. 1971).

This Court has far better things to do with its time than to consider arguments that Congress designed §11 and §12(2) to allow misleading prospectuses and registration statements, so long as care is taken to ensure that no particular sentence therein is literally false when considered in isolation.

IV. CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be denied.

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